No. 12060

In the United States Court of Appeals for the Ninth Circuit

ANNA HARRIS and MORRIS HARRIS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 51-71) are reported at 10 T. C. 818.

JURISDICTION

This petition for review involves income and victory taxes [1] for the years 1943 and 1944 in the respective amounts of $5,662.73 and $18,136.64 in the case of Anna Harris, and in the respective amounts of $6,036.87 and $18,693.10 in the case of Morris Harris. (R. 162-164.) On December 5, 1946, the Commissioner of Internal Revenue mailed notices of deficiencies to these taxpay-

[1] Although the Tax Court's decisions (R. 71-72) do not so indicate, the victory taxes are for only 1943 (R. 9, 33).

ers. (R. 8-9, 31-32.) Within ninety days thereafter, namely, on January 31, 1947 (R. 1, 17, 41), the taxpayers filed petitions with the Tax Court for the redetermination of such deficiencies pursuant to Section 272 of the Internal Revenue Code (R. 4-7, 27-30).

A motion to consolidate these cases was granted January 29, 1948. (R. 2.) Motion to file amended petitions was also granted February 11, 1948, and the amended petitions were filed on the same day. (R. 2, 19-24, 43-48.)

On May 12, 1948, the Tax Court entered its decisions sustaining the deficiencies as determined by the Commissioner. (R. 71-72.) Within three months thereafter, namely, on August 4, 1948, a petition for review by this Court was filed (R. 162-164) pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTIONS PRESENTED

1. Whether the Tax Court correctly held that the taxpayers' son and daughter were not bona fide partners for income tax purposes in the partnership operating as Union Manufacturing Company, and that each of the taxpayers here, who are equal partners therein, is subject to tax, under Section 22 of the Internal Revenue Code, on one-half of the income of such partnership.

2. Whether, in computing their victory tax net income for 1943, as defined in Section 451 of the Internal Revenue Code, the taxpayers are entitled to deduct amounts paid as income taxes to the State of California.

STATUTE AND RULING INVOLVED

The pertinent provisions of the applicable statute and ruling are set out in the Appendix, *infra*.

STATEMENT

The pertinent facts as found by the Tax Court (R. 52-59) are as follows:

The taxpayers here are Morris Harris and Anna Harris. They are husband and wife, and residents of Los Angeles, California. Albert J. Harris and Betty Harris are their children and were nineteen and sixteen years old, respectively, in 1943, the first taxable year. (R. 52.)

The taxpayers had been associated together in the partnership known as the Union Manufacturing Company for many years prior to 1943, and each owned a one-half interest in such partnership under a written agreement which is dated April 1, 1937, and covers a term of ten years. (R. 52-53.)

Morris Harris began this enterprise in 1909, and has been the manager of the business, which is the manufacture and sale of work and sport clothes for men. The capital employed has been built up by retaining profits from year to year. In 1941 the volume of sales was around \$2,000,000. In 1942, about four hundred people were employed in the Los Angeles plant and in the El Paso, Texas, plant there were around one hundred people employed, but the employment in the latter plant increased later on to about three hundred. Morris Harris owns the land and building where the Los Angeles plant is located, and it does not appear as an asset in the balance sheet of the firm. In 1942 that plant and real estate had a value of around \$300,000, without equipment. The equipment which is used in the plant consists of all kinds of machinery and sewing machines. (R. 53.)

In the manufacturing departments there are several floor ladies under one superintendent. The goods manufactured are sold all over the United States. In

1942, the market was limited to the Rocky Mountain and Pacific Coast regions and ten or twelve salesmen were employed on a commission basis, but thereafter goods were sold in chain stores. Morris receives a salary of about $200 a week which constitutes a drawing account against his share of the profits. (R. 53-54.)

As of December 31, 1942, the Union Manufacturing Company had assets of $945,975.23, of which inventory amounted to $538,992; and liabilities amounted to only $9,065.40, leaving net assets of $936,909.83. On that date, after the addition of one-half of 1942 profits, the balance of the capital account of Morris Harris was $471,351.04; and the balance of the capital account of Anna Harris was $465,558.79. (R. 54.)

The items on the balance sheet of the partnership as of December 31, 1942, are set forth in the record at pages 54-55.

The taxpayers' son Albert finished high school in June, 1941, and then attended the University of Virginia for one year. During the summer of 1942 he attended evening classes at the University of Southern California, where he took special courses in textiles. In September, 1942, he entered the textiles school of the University of North Carolina, and enlisted in the Army in December, 1942, but remained at the University until April, 1943, when he was called for active duty. (R. 55-56.)

The taxpayers' daughter Betty attended school during the years 1943 and 1944 either in high school or college. (R. 56.)

In 1942, in the summer months and at Christmas, taxpayers discussed the matter of making a gift of an interest in the partnership to their son, and considered it fair to do the same for their daughter. The arrangement discussed was not carried to any formal agreement. Thus there was no written agreement, and there

were no instruments of gifts or assignments or transfers drawn up or executed. In the discussions, Anna Harris was to make a gift of a part of her partnership interest to her son and Morris Harris was to make a gift of part of his interest to his daughter. The gifts were to be made on or about January 2, 1943. (R. 56.)

On September 16, 1943, book entries were made in the capital accounts of Anna and Morris Harris, and ledger sheets were made opening capital accounts in the names of Albert and Betty. However, the book entries did not show that the transfers were made as the parties had intended, nor did the entries correspond with the two gift tax returns of the taxpayers which were dated September 27, 1943. Instead, the capital account of Morris Harris was debited on September 16, 1943, with the amount $34,083.70, and a capital account in the name of Albert Harris was credited with the same amount as of January 1, 1943, by a transfer from the capital account of Morris Harris. Also, the capital account of Anna Harris was debited on September 16, 1943, in the amount of $34,083.70; and a capital account in the name of Betty Harris was credited with the same amount as of January 1, 1943, by transfer from the capital account of Anna Harris. (R. 56-57.)

The business of Union Manufacturing Company was conducted during 1943 and 1944 in the same way as it had been conducted in 1942 and prior years. No services were rendered to or in the business by the children, Albert and Betty, during 1943 and 1944, and neither contributed any capital of his own to the existing partnership business in those years or earlier years. (R. 58.)

When, prior to 1943, Albert went to the place of business to do work of some general type which a school boy could do, after school hours and during school vacations, he was not paid any amount. (R. 58.)

Neither Albert nor Betty withdrew any sum from the Union Manufacturing Company during 1943 and 1944. However, debits to each of their capital accounts were made at the end of 1942 and 1943 for taxes on income which was attributed to each one under bookkeeping entries made in their capital accounts. At the end of 1943 and 1944, each of these capital accounts was credited with one-sixteenth of the earnings for each year. At the end of 1943, the balance in each of their capital accounts was $46,074.86. (R. 58.)

The Tax Court found that Albert and Betty Harris were not bona fide members of the partnership here in 1943 and 1944 and that there continued to be only two partners in those years. (R. 59.)

Personal income taxes for the year 1942 were paid to the State of California by Morris Harris in the amount of $26,746.65, and by Anna Harris in the amount of $25,256.18. In computing their victory tax liability for the year 1943, taxpayers deducted the above amounts of California tax in their respective returns. The Commissioner disallowed each deduction in determining each taxpayer's net income subject to 1943 victory tax. (R. 59.) The Tax Court approved the Commissioner's determination on this issue. (R. 66-71.)

SUMMARY OF ARGUMENT

1. The question of whether the taxpayers' son and daughter can be treated as partners for income tax purposes during 1943 and 1944 depends on whether the taxpayers (who were already equal partners in an established business) and their two minor children intended to carry on a partnership business. The legal principles applicable here have been announced in many decisions holding that the so-called family partnership, although it may be valid under state laws, will not be recognized for income tax purposes if the arrange-

ment produces no real change in the conduct of the business and in the creation of the income therefrom but results merely in a reallocation of the income within the family unit. These cases point out further that in determining the question here, the Tax Court should consider the agreement of the parties and their conduct thereunder, giving particular attention to whether the alleged partners (i.e., the son and daughter here) have contributed any capital originating with them, whether they have contributed substantially to the management and control of the business and whether they have performed any vital additional services.

In applying these established principles, the Tax Court found that the children here had made none of the required contributions, that after an interest in the partnership was allegedly given to the children by their parents, the business of the partnership was carried on exactly as before, and that the parents continued to be the owners of the partnership. Consequently, the Tax Court properly held that the children should not be recognized as partners for income tax purposes during the taxable years.

2. The taxpayers also claim that in computing their victory tax net income for 1943, they are entitled to deduct the California income tax which they paid. The statute allows a taxpayer, in making such computation, to deduct taxes only to the extent that they are paid or incurred in carrying on a trade or business, or in connection with property used in business or in the production of income. The California income tax does not come in any of these categories. Thus the Tax Court correctly denied the deductions claimed by the taxpayers.

ARGUMENT

I

The Taxpayers' Children Were Not Bona Fide Partners for Income Tax Purposes in the Union Manufacturing Company During the Taxable Years, and the Income Therefrom Which Is Claimed by Them Should Be Treated for Income Tax Purposes as Belonging to Their Parents

The first issue in this case is whether the portion of the income of the Union Manufacturing Company attributed to Albert and Betty Harris, son and daughter of the taxpayers here, was includible in the gross income of the latter for the taxable years 1943 and 1944 under the provisions of Section 22 (a) of the Internal Revenue Code (Appendix, *infra*). The Tax Court held that Albert and Betty Harris were not bona fide partners for tax purposes during those years, and that their parents were taxable on all the income from the above company.

This case follows the usual pattern of the "family partnership" cases and actually differs in no material respect from many other cases which have been decided by the Supreme Court,[2] by this Court,[3] and other Courts of Appeals [4] against the claims of taxpayers who have

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[2] *Commissioner* v. *Tower,* 327 U.S. 280, and *Lusthaus* v. *Commissioner,* 327 U.S. 293, are considered the controlling cases on this issue.

[3] *Nordling* v. *Commissioner,* 166 F. 2d 703, certiorari denied, 335 U.S. 817; *Quon* v. *Commissioner,* 165 F. 2d 215, certiorari denied, 334 U.S. 845.

[4] See e.g., Second Circuit: *Seifert* v. *Commissioner,* 157 F. 2d 719; *Seibert* v. *Commissioner,* 156 F. 2d 227; *Miller* v. *Commissioner,* 150 F. 2d 823; *Waldburger* v. *Helvering,* 131 F. 2d 598. Third Circuit: *Eisenberg* v. *Commissioner,* 161 F. 2d 506, certiorari denied, 332 U.S. 767; *Davis* v. *Commissioner,* 161 F. 2d 361; *Walker* v. *Commissioner,* 160 F. 2d 313. Fourth Circuit: *Wilson* v. *Commissioner,* 161 F. 2d 556, certiorari denied, 332 U.S. 769; *Mauldin* v. *Commissioner,* 155 F. 2d 666; *Hash* v. *Commissioner,* 152 F. 2d 722, certiorari denied, 328 U.S. 838, rehearing denied, 328 U.S. 879; *Economos* v. *Commissioner,* 167 F. 2d 165, certiorari denied, 335 U.S. 826. Fifth Circuit: *Scherf* v. *Commissioner,* 161 F. 2d 495,

unsuccessfully advanced many ingenious arguments why their wives, children, or other members of their families should be recognized as their partners for tax purposes under Sections 22, 181, 182, and 183 of the Internal Revenue Code (Appendix, *infra*).

These cases hold that a family partnership based upon the transfer of so-called partnership interests from a taxpayer to his wife or other members of his family is not entitled to recognition, for income tax purposes, even though valid under state law and as to third parties, if the arrangement produces no change in the conduct of the business and in the creation of the income therefrom, but amounts merely to a reallocation of income among members of the family involved. In discussing the principles to be applied in such cases, the Supreme Court stated in *Commissioner* v. *Tower,* 327 U. S. 280, 286-287, 289:

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. When the existence of an alleged partnership arrangement is challenged by outsiders, the question

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certiorari denied, 332 U.S. 810; *Benson* v. *Commissioner,* 161 F. 2d 821; *Belcher* v. *Commissioner,* 162 F. 2d 974, certiorari denied, 332 U.S. 824; *Mead* v. *Commissioner,* 131 F. 2d 323, certiorari denied, 326 U.S. 762; *Blalock* v. *Allen,* 151 F. 2d 927. Sixth Circuit: *Hougland* v. *Commissioner,* 166 F. 2d 815, certiorari denied, 334 U.S. 846; *Weinstein* v. *Commissioner,* 166 F. 2d 81; *Dawson* v. *Commissioner,* 163 F. 2d 664; *Lowry* v. *Commissioner,* 154 F. 2d 448, certiorari denied, 329 U.S. 725; *Lorenz* v. *Commissioner,* 148 F. 2d 527, certiorari denied, 327 U.S. 786; *Thorrez* v. *Commissioner,* 155 F. 2d 791; *Epps* v. *Commissioner,* 164 F. 2d 482. Seventh Circuit: *Appel* v. *Smith,* 161 F. 2d 121; *Tinkoff* v. *Commissioner,* 120 F. 2d 564. Eighth Circuit: *Doll* v. *Commissioner,* 149 F. 2d 239, certiorari denied, 326 U.S. 725; *Supornick* v. *Commissioner,* 150 F. 2d 110. Tenth Circuit: *Earp* v. *Jones,* 131 F. 2d 292, certiorari denied, 318 U.S. 764; *Grant* v. *Commissioner,* 150 F. 2d 915; *Bradshaw* v. *Commissioner,* 150 F. 2d 918; *Losh* v. *Commissioner,* 145 F. 2d 456.

> arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. *And their intention in this respect is a question of fact, to be determined from testimony disclosed by their "agreement, considered as a whole, and by their conduct in execution of its provisions."* * * * We see no reason why this general rule should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes.
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> *The issue is who earned the income and that issue depends on whether this husband and wife really intended to carry on business as a partnership.* (Italics supplied.)

Thus the primary issue in family partnership cases, as in all tax cases, is who earned the income, and in order to treat members of a family as partners for tax purposes it must be found that they actually intend to carry on the business as partners. To determine such intent the Tax Court should examine not only the agreement of the parties but also their conduct in carrying it out. In this connection, the Supreme Court called attention in the *Tower* case (p. 290) to three tests which the Tax Court should consider and apply in the course of its examination of the facts, namely, (1) whether the wife (the alleged partner in that case) contributed any capital originating with her, (2) whether she contributed substantially to the management and control of the business in the taxable years, and (3) whether she performed any vital additional services in those years. Under the ruling in the *Tower* case, it is clear that if the Tax Court finds, as it found here, that the alleged partners have not made any of these contributions, then it may properly decide that such persons should not be treated as partners for income tax purposes.

As counsel appear to object to the application of the above tests to the facts here, we take the liberty of referring in some detail to other statements in the *Tower* case which indicate that counsel do not correctly interpret that case, as well as other cases cited herein. It will be seen that counsel not only state (Br. 20) that the three tests listed in the *Tower* case are "merely *some* of the facts to be considered in arriving at an ultimate decision," but also seem to take the position that even when no contributions of capital or services are made by the alleged partners, the Tax Court may still find that the parties intend to carry on a business as a partnership if there has been a valid gift of an interest in the business to the alleged partners. But, in taking such a position, we submit that counsel have failed to give due significance not only to the general principles governing partnerships but also to what matters the Tax Court may properly consider in determining the question as to the intent of the alleged partners. That the contributions of the alleged partners may be determinative of such question was clearly indicated by the Supreme Court in the *Tower* case when it said (p. 290):

> There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other, purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner as contemplated by 26 U. S. C. §§ 181, 182. * * * *But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within*

> *the meaning of the federal revenue laws.* (Italics supplied.)

Thus the Supreme Court held that in deciding the issue here the Tax Court *may properly* take into consideration whether the alleged partner has rendered services and contributed capital; and it follows from what was said in the *Tower* case, and the other cases cited herein, that when no vital services have been rendered and no capital contributed, the Tax Court may properly find that the parties did not intend to carry on the business as a partership and are not partners for tax purposes. Consequently, the Tax Court was fully within its authority when it applied the three tests listed above to the facts of this case; and it did not have to consider other facts since all three of the tests referred to are absent here. But, as we shall point out below, the Tax Court did consider other facts and, on the basis of all the facts, reached the conclusion that the children could not be treated as partners for tax purposes.

It appears that the primary reason for the different view adopted by the taxpayers is that they have failed to recognize the basic issue in such cases as this although such issue was emphasized throughout the opinion in the *Tower* case. As to this, the Supreme Court said (pp. 283, 290-292):

> And we have held *that the dominant purpose* of all sections of the revenue laws, including these, *is "the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid."* * * * *The basic question* in deciding whether the Commissioner's deficiency assessment was proper, is: Was the income attributed to the wife as a partner income from a partnership for which she alone was liable in her "individual capacity," * * * *or did the husband, despite the claimed partnership, actually*

create the right to receive and enjoy the benefit of the income, so as to make it taxable to him under §§ 11 and 22 (a)?

* * * * * * *

It is the command of the taxpayer over the income which is the concern of the tax laws. * * * And income earned by one person is taxable as his, if given to another for the donor's satisfaction. * * *

Judged by the actual result achieved, the Tax Court was justified in finding that the partnership here brought about no real change in the economic relation of the husband and his wife to the income in question. * * * After the partnership was formed the husband continued to control and manage the business exactly as he had before. * * * *No capital not available for use in the business before was brought into the business as a result of the formation of the partnership.* * * * *Consequently the result of the partnership was a mere paper reallocation of income among the family members. The actualities of their relation to the income did not change.* (Italics supplied.)

It is clear from the above statement that in determining the question here, the Tax Court was required to decide who had actually earned the income either by contributing property or by rendering services. Moreover, when the capital used in the business after the formation of the alleged partnership is exactly the same as that available previously, alleged partners, who may have title to a share of such capital by reason of a gift, will not be treated for tax purposes as having made a contribution to capital.

The facts here show that the taxpayers' children did not contribute any capital originating with themselves; they did not help in the management or control of the business and neither rendered any services. (R. 58, 112.) The daughter was 16 years old in 1943; she at-

tended school during both taxable years and rendered no services of any kind to the Union Manufacturing Company. (R. 52, 56, 64, 106.) It is also not disputed that the son rendered no services to the business during the years here involved. He was only 19 in 1943, and was in college until April of that year when he was called for active duty in the armed forces and remained in the Army throughout the remainder of the taxable period here. (R. 52, 55-56, 91-92, 115-117.) It is true that the son was interested in textiles and had done some work around the plant and office of the Union Manufacturing Company, but these jobs were done without pay and always during vacations. Moreover, such services were entirely before the taxable years and were not substantial or important. (R. 55, 65.)

In view of these undisputed facts, the Tax Court properly found that neither of the children had made any of the contributions referred to in the *Tower* case, *supra.* But, in reaching its conclusion that the parties did not actually intend for the children to join in the business as partners, the Tax Court also considered other facts. These include the youthfulness and inexperience of the children, which we have just referred to, also the fact that when partnership interests were allegedly given to the children no new capital was added to that which the parents had previously supplied, and the fact that the father, as manager, continued to carry on the business exactly as before the alleged gifts were made.

In this connection, the Tax Court also noted that there was no written partnership agreement (R. 88-89), nor was there any formal transfer of any interest in the business to the children. There were entries in the books of the partnership between Mr. and Mrs. Harris indicating that a capital account was set up for each of the children on September 16, 1943. But, as the Tax

Court pointed out (R. 66), there is no evidence to show just what were the terms of the alleged oral agreement with the children, but it can be inferred from the conduct of the business thereafter that it was to be run as before with Mr. Harris acting as manager and in control. This conclusion of the Tax Court is substantiated by the testimony of Mrs. Harris who stated that she was familiar with the business, that it was operated in the same manner in the taxable years as it always had been, and that her son performed no services in 1943 and 1944. (R. 103-105.)

In view of what has already been said herein, we do not consider it necessary to reply to the taxpayers' assertion (Br. 16) that the Tax Court made no specific finding as to the validity of the gifts, and erred in not doing so. Actually, the Tax Court did consider "whether bona fide gifts in praesenti were made" (R. 60) and, after a discussion of the facts, both as to Betty and Albert, the Tax Court held specifically that the evidence was not sufficient to show that a bona fide gift of a present interest in the business had been made to either one (R. 64-66). However, we repeat that the important factor here is not whether valid gifts were made but whether the parties actually intended for the children to join in the partnership business.

It may be, now that Albert is actually participating in the business, after a three-year absence in the Army (R. 118), that he could be considered as a partner today but that is not the question before us here. Our question is whether Albert and his sister Betty were partners in 1943 and 1944. It seems to be conceded by counsel that the situation is different as to Betty and that the facts are weaker as to her. (Br. 29.) But we submit that the facts do not show that either one was a partner in our taxable years or that they intended to be.

The taxpayers rely on the fact that Albert was interested in textiles and had expressed the wish to help his father carry on the business. Yet it was at their earnest solicitation that he decided to continue his college studies rather than go into the business. Because he made that decision Mrs. Harris said that they gave him an interest in the business but only as an inducement for him to go on to school. (R. 87.) This is also brought out in Albert's testimony when he explained that he had talked with his father about going into the business and in December, 1942 "was anxious to go in then", but that his parents wanted him to go back to school. As to this he said, "they said they would give me this, but I had to go back though for at least another year. * * * it was understood I would go back until at least, I had a knowledge so I could go about the business". (R. 120-121.) Clearly, this testimony, even when given the most favorable interpretation for the taxpayers, shows that they did not intend for Albert to come into the business immediately. Moreover, Albert joined the Army in December, 1942 (R. 55), so it was known long before the book entries were made in September, 1943, or anything else was done about the alleged partnership with the children that Albert would be prevented by his Army service from actually participating in the business then. Cf. *Davis* v. *Commissioner,* 161 F. 2d 361 (C. A. 3d).

The taxpayers have cited a number of cases which they assert support their position here. However, these are distinguishable on their facts with the possible exception of *Culbertson* v. *Commissioner,* 168 F. 2d 979 (C. A. 5th), but this case is now pending in the Supreme Court on a writ of certiorari granted December 6, 1948. It should also be noted that even though it was held that the father there was in partnership with his sons who intended to participate in the busi-

ness at some future time, it was recognized that the daughter, who also received a share of the business, was not a partner as it was not intended that she would ever contribute any services or capital thereto. As to the situation of minor children, also see *Wilson* v. *Commissioner,* 161 F. 2d 556 (C. C. A. 4th), certiorari denied, 332 U. S. 769.

It should also be noted that in *Lawton* v. *Commissioner,* 164 F. 2d 380 (C. C. A. 6th), the children had rendered valuable services to the business involved there, and in *Wilson* v. *Commissioner,* 161 F. 2d 661 (C. C. A. 7th), it was decided that the taxpayer's wife was a partner because she had contributed important services and money of her own. Thus, in both of these cases, on which the taxpayers rely, the courts were careful to apply the tests laid down in the *Tower* case, and to point out that the parties met such tests and did intend to carry on the business as a partnership. Such tests were also applied by this Court in *Nordling* v. *Commissioner,* 166 F. 2d 703, certiorari denied, 335 U. S. 817, in which it was found that the wife was not a partner for income tax purposes since she had contributed no capital of her own and had rendered only negligible services to the business.

II

State Income Taxes Are Not Deductible in Computing Victory Tax Net Income

The Commissioner determined that the taxpayers are not entitled to deduct the amount of California income tax which they paid in computing the amount of their victory tax net income in 1943. The Tax Court upheld the Commissioner's determination on this issue also.

Victory tax net income is defined in Section 451 (a) of the Internal Revenue Code (Appendix, *infra*) as gross income (with certain exceptions not material

here) minus the sum of the deductions listed therein and including taxes as follows:

> Amounts allowable as a deduction by section 23 (c), to the extent such amounts are paid or incurred in connection with the carrying on of a trade or business, or in connection with property used in the trade or business, or in connection with property held for the production of income.

Taxes which may be deducted under Section 23 (c) (Appendix, *infra*), referred to above, include all taxes except certain ones listed therein. Thus, since state income taxes are not listed as one of the exceptions, they can be deducted under Section 23 (c) in computing ordinary net income. But, obviously, to compute victory tax net income under Section 451(a), it is necessary to consider something in addition, namely, it must also be shown that the state income taxes involved were paid or incurred (1) in connection with the carrying on of a trade or business, or (2) in connection with property used in the trade or business, or (3) in connection with property held for the production of income. In holding that the California income taxes could not be deducted here, the Tax Court stated (R. 68-69):

> It is our understanding that the California income tax is a personal income tax which, like the Federal income tax, is imposed upon income derived from all sources. * * * Petitioners argue that the state income tax was a tax which was paid or incurred in connection with the carrying on of a business within the meaning of section 451 (a)(3) because the income which was taxed by the state was derived from a business.
>
> The construction which the petitioners would have placed upon section 451 (a)(3) does not, in our opinion, give proper consideration to the wording of the pertinent section. The state income tax was not incurred "in connection with the carry-

> ing on of the business." Those words have a clear meaning, but, if it is necessary to undertake to clarify them, we think that the words mean a tax which is incurred as an incident to the carrying on of business in the sense that a business expense is incurred in carrying on a business; that is to say, something which must be paid in order to do business.

We submit that the Tax Court correctly interpreted the statute. As this Court undoubtedly knows, the California statute, under which the taxpayers paid income tax to that state in 1943, was entitled "The Personal Income Tax" (3 Deering's California General Laws, Act 8494) and contained many provisions very similar to those found in the federal income tax law. This is particularly true as to the definitions of net and gross income, and as to its treatment of partnerships (see Sections 6.7 and 22 of Act 8494 of Deering's California General Laws, *supra*). Thus it seems evident, as the Tax Court held, that the California income tax is a personal income tax like the federal income tax and is imposed on income from all sources. Accordingly, we submit it is not a tax which is paid as an incident to carrying on a business and does not come within any of the provisions of Section 451 (a), referred to above.

It does not appear that the specific question here has been involved in any other case. However, in enacting the provisions of Section 451 (a), the Committee on Finance (S. Rep. No. 1631, 77th Cong., 2d Sess., p. 8 (1942-2 Cum. Bull. 504, 509)) made the following significant comment in regard to it:

> Since the Victory tax does not allow any deduction for State income taxes, your committee deemed it advisable to provide that the total income tax and Victory tax should not exceed 90 per cent of the taxpayer's net income.

Also see I. T. 3644, 1944 Cum. Bull. 372-373 (Appendix, *infra*), in which it was held that personal income taxes are not deductible in computing victory tax net income under Section 451 (a).

The taxpayers rely on another ruling of the Commissioner (I. T. 3829, 1946-2 Cum. Bull. 38) in which it was held that a taxpayer might deduct such portion of the Indiana gross income tax as was attributable to a trade or business. But it should be noted that I. T. 3829 referred to the computation of "adjusted gross income"[5] and here we are concerned with a different computation, namely, the computation of "victory tax net income". These are technical terms referring to sums which must be computed exactly as the statute indicates. Thus it does not follow that what may be done in making one computation may be done in the other. Moreover, as we have already pointed out, it was not the intention of Congress to allow state income taxes to be deducted in computing victory tax net income. However, even if we are wrong in our interpretation of Section 451 (a) and a state income tax can be properly deducted, it still must be shown that such tax is paid or incurred as an incident to the carrying on of a trade or business, and the taxpayers have not done so. Counsel merely assert (Br. 31) that state income taxes paid upon income derived from the operation of a business are paid in connection with the carrying on of such business but they point to no evidence here showing the source of the income on which the state taxes here

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[5] That term is defined in Section 22 (n) of the Internal Revenue Code, as added by Section 8 (a) of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231, as gross income minus certain deductions including—

> (1) *Trade and business deductions.*—The deductions allowed by section 23 which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee; * * *.

were paid. While it may be true that most of the income here was derived from the partnership business, neither the federal nor state personal income tax return was produced and there is no evidence to support the taxpayers' claim that the tax was paid in connection with any business.

Accordingly, the deduction was properly denied.

CONCLUSION

The decisions of the Tax Court are correct on both issues and should be affirmed.

Respectfully submitted,

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FEBRUARY, 1949.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(c) [as amended by Sec. 202 of the Revenue Act of 1941, c. 412, 55 Stat. 687; Secs. 105, 122 and 158 of the Revenue Act of 1942, c. 619, 56 Stat. 798; and Sec. 111 of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Taxes Generally.*—

(1) *Allowance in general.*—Taxes paid or accrued within the taxable year, except—

(A) Federal incomes taxes;

(B) war-profits and excess-profits taxes imposed by Title II of the Revenue Act of 1917, Title III of the Revenue Act of 1918, Title III of the Revenue Act of 1921, section 216 of the National Industrial Recovery Act,

or section 702 of the Revenue Act of 1934, or Subchapter E of Chapter 2, or by any such provisions as amended or supplemented;

(C) income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 131;

(D) estate, inheritance, legacy, succession, and gift taxes;

(E) taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges; and

(F) Federal import duties, and Federal excise and stamp taxes (not described in subparagraph (A), (B), (D), or (E)), but this subsection shall not prevent such duties and taxes from being deducted under subsection (a).

(3) *Retail sales tax.*—In the case of a tax imposed by any State, Territory, District, or possession of the United States, or any political subdivision thereof, upon persons engaged in selling tangible personal property at retail, which is measured by the gross sales price or the gross receipts from the sale or which is a stated sum per unit of such property sold, or upon persons engaged in furnishing services at retail, which is measured by the gross receipts for furnishing such services, if the amount of such tax is separately stated, then to the extent that the amount so stated is paid by the purchaser (otherwise than in connection with the purchaser's trade or business) to such person such amount shall be allowed as a deduction in computing the net income of such purchaser as if such amount consti-

tuted a tax imposed upon and paid by such purchaser.

*   *   *   *   *

(26 U. S. C. 1946 ed., Sec. 23.)

Sec. 181. Partnership Not Taxable.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U. S. C. 1946 ed., Sec. 181.)

Sec. 182. Tax of Partners.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

*   *   *   *   *

(26 U. S. C. 1946 ed., Sec. 182.)

Sec. 183. [as amended by Sec. 9 of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231].

Computation of Partnership Income.

(a) *General Rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b), (c), and (d).

*   *   *   *   *

(26 U. S. C. 1946 ed., Sec. 183.)

Sec. 451 [as added by Sec. 172 of the Revenue Act of 1942, *supra*]. Victory Tax Net Income.

(a) *Definition.*—The term "victory tax net income" in the case of any taxable year means (except as provided in subsection (c)) the gross income for such year (not including gain from the sale or exchange of capital assets as defined in section 117, or interest allowed as a credit against net income under section 25 (a)(1) and (2), or

amounts received as compensation for injury or sickness which are included in gross income by reason of the exception contained in section 22 (b) (5)) minus the sum of the following deductions:

* * * * *

(3) *Taxes.*—Amounts allowable as a deduction by section 23 (c), to the extent such amounts are paid or incurred in connection with the carrying on of a trade or business, or in connection with property used in the trade or business, or in connection with property held for the production of income.

* * * * *

I. T. 3644, 1944 Cum. Bull. 372-373:

Advice is requested as to the deductibility, in computing victory tax net income, of the personal income taxes imposed by the various States.

In computing victory tax net income, amounts of taxes allowable as a deduction by section 23 (c) of the Internal Revenue Code may be deducted under section 451 (a) (3) of the Code, as added by section 172 (a) of the Revenue Act of 1942, "to the extent such amounts are paid or incurred in connection with the carrying on of a trade or business, or in connection with property used in the trade or business, or in connection with property held for the production of income."

That Congress intended to restrict, for victory tax purposes, the deductions ordinarily allowed by section 23 (c) of the Code is evident from the language of section 451 (a) (3) of the Code, supra, and the report submitted by the Committee on Finance of the Senate (Senate Report No. 1631, Seventy-seventh Congress, second session, C. B. 1942-2, 504, at page 509), on the revenue bill of 1942, in which it is stated, in part, as follows:

Since the victory tax does not allow any deduction for State income taxes, your committee deemed it advisable to provide that the total in-

come tax and victory tax should not exceed 90 per cent of the taxpayer's net income. * * * [Italics supplied.]

It is held, therefore, that the personal income taxes imposed by the various States are not deductible in whole or in part in computing victory tax net income under section 451 (a)(3) of the Internal Revenue Code, supra.

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